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No. . . . .

IN THE

Supreme Court of the United States

October Term, 1982

THOMAS E. JOHNSTON, *et al.*,

Petitioners,

vs.

DOROTHEA NYBERG, *et al.*,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT.

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Questions Presented.

1. What is the proper culpability standard to be applied in private causes of action under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereof?

2. Should reckless behavior be accepted as adequate scienter in private causes of action under Section 10(b) and Rule 10b-5?

3. If the answer to question number two is "yes", under what circumstances should reckless behavior be sufficient to impose civil liability under Section 10(b) and Rule 10b-5?

4. By ignoring the Findings of Fact of the District Court that there was nothing in the record to justify an inference of recklessness on the part of Petitioners, did the Court of Appeals, in effect, reinstate a negligence standard previously rejected by this Court?

The parties to the proceedings below are DOROTHEA NYBERG, Trustee for Connie Louise Nyman and Larry Charles Nyman; DOROTHEA NYBERG, Executrix of the Estate of Lewis Marvin, Deceased; DOROTHEA NYBERG, an Individual; DONALD NYBERG, an Individual; MARGARET H. MARVIN, an Individual; MARGARET ELLIS, an Individual; FRED THOMSON, Co-Trustee Inland Lumber Company Profit-Sharing Trust; and LORRAINE K. WHITE, an Individual, Respondents herein, Plaintiffs-Appellants below, v. THOMAS E. JOHNSTON, an Individual; RICHARD S. HALLMARK, an Individual; VISTA DEL VERDE, INC., a corporation; VISTA DEL VERDE CORPORATION, a corporation; CONDOR INTERNATIONAL CORPORATION, a corporation; VISTA DEL VERDE COMPANY, a limited partnership; ROBERT J. KRAUSE, an Individual, Petitioners herein, Defendants-Appellees below. In addition, SHIRLEY L. JOHNSTON, an Individual; VIVIAN HALLMARK, an Individual; LOIS A. KRAUSE, an Individual, were Defendants-Appellees below and were dismissed by agreement of the parties at oral argument as spouses of the principal Petitioners. In addition, WILLIAM T. O'BRIEN, an Individual, was a Defendant-Appellee below concerning whom the Court of Appeals affirmed summary judgment.

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Petitioners, THOMAS E. JOHNSTON, RICHARD S. HALLMARK, VISTA DEL VERDE, INC. (hereinafter "VDV, INC."), VISTA DEL VERDE CORPORATION (hereinafter "VDV CORP."), CONDOR INTERNATIONAL CORPORATION (hereinafter "CONDOR"), VISTA DEL VERDE COMPANY (hereinafter "VDV COMPANY"), ROBERT J. KRAUSE, respectfully pray that a Writ of Certiorari issue to review the Judgment and Opinion of the United States Court of Appeals for the Ninth Circuit ("COURT OF APPEALS") entered in the above-entitled case on April 30, 1982.

OPINIONS BELOW.

The Opinion of the Court of Appeals filed on April 30, 1982 was rendered in a Memorandum Decision which was not reported. This Opinion appears as Appendix A hereto

(cited herein as "PET. APP. 1 ET SEQUITUR"). The District Court for the Central District of California rendered its Decision in an unpublished Memorandum of Decision filed February 2, 1981. A copy of the Memorandum of Decision of the District Court is attached as Appendix B hereto (cited herein as "PET. APP. 8 ET SEQUITUR").

JURISDICTION.

The judgment of the Court of Appeals was entered on April 30, 1982. This Petition for Writ of Certiorari has been timely filed within 90 days thereafter. (28 U.S. Code Section 2101(c); Supreme Court Rule 20.2, .4.) The jurisdiction of the Supreme Court is invoked pursuant to 28 U.S. Code Section 1254(1).

STATUTORY PROVISIONS INVOLVED.

This case involves various provisions of the Securities Exchange Act of 1934 and certain rules promulgated thereunder. The pertinent provisions of the 1934 Act are Section 10(b) of the Securities Exchange Act of 1934 codified at 15 U.S.C. Section 78(j); Section 20(a) of the Securities Exchange Act of 1934, codified at 15 U.S. Code Section 78(t); Securities Exchange Commission Rule 10b-5 codified at 17 C.F.R. 240.10b-5; and Securities Exchange Commission Regulation C, codified at 17 C.F.R. Section 230.405(f). Copies of the above-noted portions of the Securities Exchange Act and the Rules thereto are contained in Appendix C hereto. (Pet.App. 17 et sequitur.)

STATEMENT OF THE CASE.

This is a case involving an action under Section 10(b) and Rule 10b-5 thereunder of the Securities Exchange Act of 1934, as amended, (hereinafter "the Act"). Two theories of liability were alleged: (1) Section 20(a) of the Act — control person liability; and (2) case law — aider and abettor

liability. Jurisdiction of the District Court was invoked under 15 U.S. Code Section 77(e), 15 U.S. Code Section 78(aa), 15 U.S. Code Section 18(b-15), and 28 U.S. Code Section 1331.

It is alleged that Bauer and Webley (who were not parties to the appeal or to this Petition) induced Respondents to invest in certain real estate developments controlled by Petitioners. Thereafter, the Respondents brought suit against Bauer, Webley and the Petitioners, alleging that they had violated various Federal Securities laws and regulations. Petitioners successfully moved for Summary Judgment based upon the issue of scienter. In granting the motion, the District Court stated that the Respondents had failed to raise a genuine issue of material fact as to whether (1) the Petitioners were "control persons" within the meaning of Section 20(a), and (2) the Petitioners possessed the necessary element of intent in regard to Bauer's and Webley's actions.

In reversing the District Court, the Court of Appeals first based its ruling on the position that there was a genuine issue of material fact as to whether Petitioners possessed the requisite power and authority to make them "controlling persons." (Pet.App. 4.) Second, the Court of Appeals addressed the question of scienter, stating:

> "It is settled in this circuit that recklessness satisfies a scienter requirement." (Pet.App. 5.)

The Court of Appeals then *inferred* recklessness, and thereby "scienter", by virtue of Petitioners having executed trust deeds and promissory notes. Based upon this inference, the Court of Appeals reversed the District Court, holding that Summary Judgment could not be granted on the ground of lack of scienter.

REASONS FOR GRANTING THE WRIT.

I.

THIS COURT HAS NOT SETTLED, BUT NOW SHOULD SETTLE, THE QUESTION OF THE PROPER CULPABILITY STANDARD TO BE APPLIED IN PRIVATE CAUSES OF ACTION UNDER SECTION 10(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND RULE 10b-5 THEREOF.

A. The Importance of the Question.

Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 enacted thereunder provide protection from fraud and misrepresentation in the field of securities dealings. These pieces of legislation were created to redress an imbalance whereby purchasers of these commodities often were victimized by fast dealers. However, as frequently happens, applications of these rules tended to swing the pendulum too far in one direction, and sellers of securities who had no level of intention or knowing wrongdoing (or scienter) began to find themselves liable under these rules for conduct which could, at best, be characterized as negligent. To provide more balanced equities and to more accurately reflect Congress' intent, this Court in 1976 handed down its keystone decision of *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). In that case (like this one, a dismissal by summary judgment), this Court clearly stated that negligent conduct alone was insufficient to found liability in private causes of action under Section 10(b) and Rule 10b-5, stating at 425 U.S. 194:

> "We granted certiorari to resolve the question whether a private cause of action for damages will lie under Section 10(b) and Rule 10b-5 in the absence of any allegation of 'scienter' — intent to deceive, manipulate, or defraud. . . . We conclude that it will not and therefore we reverse."

In its now famous footnote 12 to the above-cited paragraph, the Court went on to provide some broad outline guidance. Noting that some circuits had held negligence alone sufficient (including the Ninth Circuit's "flexible duty" standard), the Court disapproved this standard and specifically defined scienter, 425 U.S. at 194, fn. 12:

> "In this opinion the term 'scienter' refers to a mental state embracing intent to deceive, manipulate, or defraud.

Thus, the Court provided clear guidance at the extreme ends of the spectrum: Innocent or negligent behavior *would* be insufficient for liability; intentional behavior or fraud would be sufficient for liability. However, the Court specifically left the middle ground unresolved, stating at 425 U.S. 194, fn. 12:

> "In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some acts. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under Section 10(b) and Rule 10b-5."

Over six years have now passed, with the lower Courts struggling to resolve the question left open by this Court. Certainly, the field of securities litigation has not declined in volume or importance. The state of law has now arrived at a point perhaps best defined by the oft-quoted article by Elaine Bucklo, "The Supreme Court Attempts to Define Scienter Under Rule 10b-5: *Ernst & Ernst v. Hochfelder*," 29 Stan. L.Rev. 213 (1977) at 215:

> "At first glance, therefore, *Ernst & Ernst* appears to define scienter as Humpty Dumpty would: 'It means just what [the Justices] choose it to mean — neither more nor less.' Such ambiguity leaves litigants, commentators and lower courts in doubt as to the proper

culpability standard under Rule 10b-5 and free, much as Alice feared, to 'make [the Justices'] words mean so many different things'."

B. The Court Should Settle the Question Now.

There can be little question that the time and circumstances are ripe for this Court to resolve, once and for all, the question of the proper culpability standard to be applied in private causes of action under Section 10(b) and Rule 10b-5. The lower courts have struggled and continue to struggle to find an acceptable definition. During this process, the various circuits have formulated standards which vary from one part of the country to another, and which reflect the preferences of the judges of particular circuits. Confirmation of this state of flux can be found in the words of the Second Circuit's recent case: *ITT, an International Investment Trust, Cornfeld*, 619 F.2d 909 (2d Cir. 1980) at 923:

> "Recognizing that there can be no certainty on the subject until the Supreme Court flushes out footnote 12 of *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193-94, 96 S.Ct. 1375, 138-81, 47 L.Ed.2d 668 (1976), we shall continue to follow our own decisions . . . as well as those of other Courts of Appeals with which we agree . . ."

Although *Ernst & Ernst v. Hochfelder* did appear to clarify the question of negligent behavior, in the areas left unresolved, the lower Courts have been left to guess and speculate as to the precise meaning of scienter and the implications of actions brought under Section 10(b) and Rule 10b-5. It is not surprising that, with a complex concept, the interpretations have varied. What is more troublesome is the fact that interpretations of *Ernst & Ernst v. Hochfelder* have been equally diverse. Contrasting the Ninth Circuit with the Seventh Circuit is instructive on this point. In

Nelson v. Serwold, 576 F.2d 1332 (9th Cir. 1978), the Ninth Circuit indicated an interpretation of *Ernst & Ernst* which would effectuate a liberal definition of scienter in Section 10(b) actions, stating at 576 F.2d 1337:

> "Its [*Ernst & Ernst's*] succeeding terminology, analysis, and citation to authority, however, lend credence to a broad interpretation of scienter. . . . *Ernst & Ernst*, we think, only went so far as to eliminate negligence as a basis for liability. We agree with those courts which have found that Congress intended the ambit of Section 10(b) to reach a broad category of behavior, including knowing or reckless conduct."

Thus, the Ninth Circuit has interpreted *Ernst & Ernst* to permit liberal definitions of scienter and has operated on that premise.

On the other hand, in *Sanders v. Nuveen*, 554 F.2d 790 (7th Cir. 1977), the Seventh Circuit interpreted *Ernst & Ernst* as requiring a strictly limited definition of scienter in Section 10(b) cases, indicating at 554 F.2d 793:

> "In view of the Supreme Court's analysis in *Hochfelder* of the statutory scheme of implied private remedies and express remedies, the defintion of 'reckless behavior' should not be a liberal one least any discernible distinction between 'scienter' and 'negligence' be obliterated for these purposes."

The Seventh Circuit has, therefore, adopted a distinctly limited view of scienter relying upon *Ernst & Ernst*, while at the same time, the Ninth Circuit has taken the exact opposite position based upon the same case. This state of confusion is compounded when the other nine circuits are inserted into the picture.

At this point in time, the question of scienter and the culpability standard should be resolved. Obviously there is marked disagreement among justices and circuits over the

meaning and application of scienter standards. *Ernst & Ernst* now needs to be supplemented. As noted by the leading Law Review commentator on the case, *Ernst & Ernst* has lent itself "to three inconsistent interpretations of the meaning of scienter": (1) actual or strict intent; (2) knowledge and (3) recklessness). Bucklo, "The Supreme Court Attempts to Define Scienter Under Rule 10b-5: *Ernst & Ernst v. Hochfelder*," 29 Stan. L.Rev. 213 (1977) at 218.

II.

THIS COURT HAS NOT DETERMINED, BUT NOW SHOULD DECIDE, WHETHER RECKLESS BEHAVIOR IS SUFFICIENT FOR CIVIL LIABILITY UNDER SECTION 10(b) AND RULE 10b-5.

A. Possible Approaches for This Court.

Having eliminated negligence as a basis for liability in a private action under Section 10(b) and Rule 10b-5 in the *Ernst & Ernst* case, this Court now has a philosophical scale of choices for imposing liability. In accordance with *Ernst & Ernst*, some degree of scienter must lie for a private 10b-5 action to succeed.

The court may, and should, affirm that intentional wrongdoing or intentional fraud is a clear showing of the requisite scienter. This would be a clear reading of the intent of Section 10(b) of the Securities Exchange Act of 1934.

The court might also choose to include knowledge or actual knowledge of the fraud as adequate scienter for Rule 10b-5 actions. Such a position encompasses a variety of fact situations, however, which might posit liability in marginal cases. The most immediate question, especially with secondary Defendants (such as Section 20 "control persons" or common law "aiders and abettors"), is whether knowledge alone, with no action on behalf of the fraud, is appropriate scienter upon which liability should be established.

Does mere knowledge alone create an affirmative duty to warn or inform potential investors? When does one acquire such a duty to warn? In the pragmatic realities of the business world, when does "one person become his or her brother's keeper"? Imposing liability for this degree of "scienter" may or may not offend basic precepts of fairness. Given the relative equities, perhaps it is not unreasonable to impose a duty of warning on those who can knowingly prevent a fraud or wrongdoing by requiring them to undertake an affirmative action to protect an innocent party. The Court may accept this option.

The third alternative is the *most* removed from actual fraud or wrongdoing. This standard would impose liability not for intent alone, not for knowledge alone, but rather for unknowing, unintentional conduct characterized as "reckless." Such a decision certainly involves policy questions as much as legal issues, and should be approached with great care. In its now-famous footnote 12 to the *Ernst & Ernst* decision, this Court reserved the question of ". . . whether, in some circumstances, reckless behavior is sufficient for civil liability under Section 10(b) and Rule 10b-5." 425 U.S. at 194.

B. The Position Taken by the Circuit Courts of Appeal.

Given the opening provided by footnote 12, noted above, the various Circuits were forced to develop answers for themselves. To date, six Circuits specifically indicate that reckless behavior is sufficient (the Second, Third, Fifth, Sixth, Seventh, and Ninth); three Circuits have not overtly addressed the issue but have indirectly, and by approving references to the first six Circuits, accepted the reckless standard (the First, Eighth, and Tenth); one Circuit has recognized that most others have adopted the standard while declining as yet to do so itself (the DC Circuit); one Circuit

does not appear to have addressed the issue at all (the Fourth).

The mere fact of the acceptance of the reckless standard by the above-mentioned Circuits does not, in itself, argue in favor of this Court's acquiescence in this direction. The best that can be said for the positions of the various Circuits is that they are fluid. As is pointed out by Elaine Bucklo, "however, since the last word has not been said regarding recklessness, the lower courts lack necessary guidance in deciding 10b-5 cases, as evidenced by the already numerous decisions attempting to interpret *Ernst & Ernst*." Bucklo, "The Supreme Court Attempts to Define Scienter Under Rule 10b-5: *Ernst & Ernst v. Hochfelder*," 29 Stan. L.Rev. 213 (1977) at 227.

The *internal* inconsistencies within many of the Circuits reflect, at best, indecision as to the approach to be taken concerning recklessness as adequate scienter. Thus, the Second Circuit pointed out the possible complexity of the issue in *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156 (2d Cir. 1980) at 167 wherein it stated:

> "The Supreme Court, in *Ernst & Ernst v. Hochfelder, supra,* ruled that scienter is an essential element of a Section 10(b) violation, *leaving to the lower Courts the meaning of scienter in various contexts*." [emphasis added]

Clearly, "the meaning of scienter in various contexts" is precisely what has created confusion to date. Likewise, the Sixth Circuit has experienced some uncertainty as to the direction it wishes to go concerning the recklessness standard. In *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017 (6th Cir. 1979) at p. 1024, the Court announced:

> "Cases abound which hold that the section 10(b)/Rule 10b-5 claim for relief is to be liberally construed in order to effectuate the policies underlying the federal

> securities laws . . . . In line with that rule of construction, we should construe the Section 10(b)/Rule 10b-5 claim no more narrowly than required by *Hochfelder*."

This liberal approach to defining scienter was then brought into question in the later case of *Adams v. Standard Knitting Mills, Inc.*, 623 F.2d 422 (6th Cir. 1980) wherein the Court appeared to adopt a much more restrictive definition of scienter and recklessness. This apparent shift in policy led the dissent to point out at 623 F.2d 443:

> "In *Mansbach* . . . we upheld the sufficiency of recklessness to establish civil liability under the Act and that such claims should be liberally construed in order to effectuate the policies underlying the federal securities laws. [In a footnote to the above-cited sentence, the dissent added] The majority opinion impliedly overrules our decision in *Mansbach* but this is not an uncommon practice in our court for one panel to overrule the decision of another panel. . . ."

Within the period of one year, the Sixth Circuit has had obvious difficulties in arriving at a proper standard to apply in § 10(b) cases. Nor is the Sixth Circuit alone.

The Fifth Circuit also appears to be caught in a web of confusion as to the appropriate definition of recklessness. Two cases, both in 1981, seem to indicate a somewhat contrary approach. The earlier case of *G. A. Thompson & Co., Inc. v. Partridge*, 636 F.2d 945 (5th Cir. 1981) discusses the state of law in other Circuits concerning the degree of scienter required for liability of a control person. Citing both the Third Circuit's more restrictive rule and the Fourth Circuit's more liberal rule, the Court appeared to adopt the more liberal approach, noting in footnote 32 at 636 F.2d at 961:

> "We also observed two primary substantive reasons supporting our holding that recklessness should be sufficient to give rise to liability under 10b-5. First, Rule 10b-5 should be liberally construed to effectuate the purposes of the 1934 Act . . ."

This liberal approach appeared to be under question two months later in *Broad v. Rockwell International Corp.*, 642 F.2d 929 (5th Cir. 1981). In an extended discussion of its standard of scienter — severe recklessness — the Court went on to restrictively define that standard:

> "Severe recklessness is limited to those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it."

This latter definition would scarely seem to be a "liberal" interpretation of the recklessness standard and the scienter requirement.

Finally, and more directly to the point, the Ninth Circuit itself seems caught in a whirlpool of its own making concerning the appropriate standard of scienter. In *Little v. Valley National Bank of Arizona*, 650 F.2d 218 (9th Cir. 1981) the Court reflected on its own "flexible duty" standard. The Court stated in footnote 4, 650 F.2d at 222:

> ". . . *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974), decided before *Ernst & Ernst*, held that Rule 10b-5 imposed a 'flexible duty' the requirements of which depend on the role played by the defendant in the alleged violation. In *Arthur Young & Co. v. United States District Court*, 549 F.2d 686, 695-96 (9th Cir. 1977), this court observed in dictum that little was left

> of the flexible duty standard after *Ernst & Ernst*. Oddly enough, this court then applied the *White v. Abrams* standard in *Zweig v. Hearst Corp.*, 594 F.2d 1261 (9th Cir. 1979), without any reference to *Arthur Young*. See also *Spectrum Financial Companies v. Marconsult, Inc.*, 608 F.2d 377, 382-85 (9th Cir. 1979) (Ferguson, J., concurring specially)."

Thus, although the Supreme Court specifically disapproved the *White v. Abrams* "flexible duty" standard in *Ernst & Ernst*, the Ninth Circuit appears to have sporadically applied this standard anyway. This, of course, is what has brought the immediate Petition to this Court.

The discussion of Judge Ferguson in his special concurring Opinion in *Spectrum Financial Companies v. Marconsult, Inc.*, 608 F.2d 377 (9th Cir.1979) is especially revealing. In that Opinion, Judge Ferguson noted at 608 F.2d at 383-84:

> "In the three years since the Supreme Court decided *Hochfelder*, overruling the 'flexible duty' negligence standard of *White v. Abrams* in favor of a form of scienter involving more than negligence, this Circuit has addressed the question of *White v. Abrams*' continuing vitality several times — with varying results. [Judge Ferguson then goes on to discuss conflicting decisions in the Ninth Circuit dealing with the 'flexible duty' standard] . . . I believe that a re-examination of the flexible duty standard in light of *Hochfelder* shows that the time has come to lay *White v. Abrams* to rest. The five-factor duty analysis helps a court evaluate the foreseeability of harm to a plaintiff from the defendant's actions and the level of culpability of the defendant's conduct. These evaluations are relevant, and even necessary, to a finding of liability based on negligence. After *Hochfelder*, *supra*, and *Nelson v. Serwold*, *supra*, however, 10b-5 liability requires proof

> of recklessness, and the duty analysis is no longer appropriate. [Following additional discussion of the difficulties of the flexible duty standard in the case before that court, Judge Ferguson concludes] . . . We may avoid this problem quite easily by recognizing that the flexible duty negligence standard is just that — a negligence standard. We have followed the Supreme Court's dictates in *Hochfelder* and required scienter instead of negligence. We should recognize that it is, therefore, no longer appropriate to apply a duty standard that was designed to compartmentalize and simplify a negligence inquiry."

The above-cited cases reveal that the Ninth Circuit has created an untenable situation for District Court judges and litigants. It is impossible to determine what standard of scienter applies from case to case. This is a further argument in favor of the Supreme Court's resolving the confusion.

C. Problems Created by the Recklessness Standard.

Application of the recklessness standard leads, inevitably, to certain problems. Although the desire to protect innocent investors/sellers of securities is admirable and desirable, it could not have been the intent of Congress to penalize other innocent parties. As this court noted in *Ernst v. Ernst v. Hochfelder*, 425 U.S. 185 (1976) at 198 ". . . Section 10(b) was intended to proscribe knowing or intentional misconduct." To extend liability to innocent parties, even careless or reckless parties, is to take a tenuous step in a perilous direction. This is especially true with secondarily liable parties, such as "control persons" as contemplated by Section 20 of the Securities Exchange Act of 1934 (15 U.S.C. Section 78(t)) attached as Appendix C hereto (cited herein as Pet.App. 20). It makes little sense to interpret the Act in such a way as to protect innocent investors/sellers of securities at the expense of other parties who have evinced

no sign of willful or knowing wrongdoing. Such an approach would be offensive to basic concepts of fairness and equity. As has been recognized by several circuits, "the scienter requirement scales upward when activity is more remote." *Woodward v. Metro Bank of Dallas*, 522 F.2d 84 (5th Cir. 1975); *ITT, an International Investment Trust v. Cornfeld*, 619 F.2d 909, 923-25 (2d Cir. 1980).

An additional consideration which should be kept in mind at all times is the effect of the rule adopted on the everyday conduct of business. This was a factor recognized by this Court in the *Ernst & Ernst* case. In footnote 33, 425 U.S. 185 at 215, the Court expressed concern that the standards imposed upon business not result in more harm than good. Again, in secondarily liable party cases, this is particularly apropos. Perhaps one of the best statements in this regard is found in *Monsen v. Consolidated Dressed Beef Co., Inc.*, 579 F.2d 793 (3d Cir. 1978) at 799 wherein the Court states:

> "Knowledge of the underlying violation is a critical element in proof of aiding — abetting liability, for without this requirement financial institutions, brokerage houses, and other such organizations would be virtual insurers of their customers against security law violations. Culpability of some sort is necessary to justify punishment of a secondary actor and mere unknowing participation in another's violation is an improper predicate to liability. (citations)"

To similar effect concerning lawyers, see footnote 3 of *Stokes v. Lokken*, 644 F.2d 779 (8th Cir. 1981) at 783 wherein the Court notes:

> "To impose a standard of independent factual inquiry in the circumstances would make it unreasonably difficult for clients to obtain expeditious legal advice, or for lawyers to maintain a busy practice."

Finally, it must be pointed out that a more restrictive requirement of scienter, especially for secondarily liable parties, does not remove a Plaintiff's remedy. At all times, the primary violater is subject to suit by the injured Plaintiff. All that the injured party need show is the fact of a fraudulent or misleading action and the requisite scienter on the part of the primary actor to recover.

III.

THE DECISIONS OF THE VARIOUS CIRCUIT COURTS OF APPEAL WHICH HAVE HELD RECKLESSNESS TO BE ADEQUATE SCIENTER FOR A 10b-5 ACTION ARE INCONSISTENT AND IN DISAGREEMENT OVER WHAT CIRCUMSTANCES RECKLESS BEHAVIOR WILL BE HELD SUFFICIENT TO IMPOSE LIABILITY.

Since the landmark case of *Ernst v. Ernst* was decided, most Circuits have either directly or indirectly accepted reckless behavior as sufficient scienter to impose civil liability under Section 10(b) and Rule 10b-5. However, the Circuit's definitions of the "recklessness" which will give rise to civil liability are in variance.

In the Circuits which have directly addressed this question, the Ninth Circuit stands in splendid isolation. It alone persists in defining recklessness in terms of a "flexible duty" standard disapproved by the Supreme Court in the *Ernst & Ernst* case. In particular, the Ninth Circuit has revealed its continuing application of this standard in *Pegasus Fund, Inc. v. Laraneta*, 617 F.2d 1335 (9th Cir. 1980) at 1340 when the Court confirmed that the decision in that case ". . . draws support from the flexible duty standard employed by this Circuit (citations)." Further, the Ninth Circuit indicated a commitment to a lesser degree of scienter in *Spectrum Financial Companies v. Marconsult, Inc.*, 608 F.2d 377 (9th Cir. 1979) with its conclusion at page 381 that:

> "Recklessness, or some degree of intent not sufficiently aggravated to be characterized as 'deliberate and cold blooded' would support liability under Section 10(b) and Rule 10b-5 (citation)."

As noted above, this Opinion gave rise to Judge Ferguson's critical special concurring Opinion. In the case at hand, the Court of Appeals has compounded its commitment to a marginal standard of scienter. In the unpublished Opinion, the Court of Appeals noted (Pet.App. 5):

> "Recklessness may be established by showing that defendants 'had reasonable grounds to believe material facts existed that were misstated or omitted, but nonetheless failed to obtain and disclose such facts.' (citation)"

This is a standard of scienter which seems, by far, more akin to a negligence standard than to intent, or knowledge, or recklessness.

In contrast to the Ninth Circuit's rather imprecise and overly-flexible approach, the other Circuits have almost uniformly adopted a stricter standard more in line with the *Ernst & Ernst* directive. Perhaps the most-quoted leading case in the Circuits is *Sundstrand Corporation v. Sun Chemical Corporation*, 553 F.2d 1033 (7th Cir. 1977). In that case is found the most widely accepted definition of recklessness (and thus scienter) in the Circuits. The *Sundstrand* Court quoted with approval and therewith adopted a definition contained in *Franke v. Midwestern Oklahoma Development Authority*, 428 F.Supp. 719, 725 (W.D. Okla. 1976), to wit:

> "Reckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is ei[illegible]

known to the defendant or is so obvious that the actor must have been aware of it."

This is the strict standard of scienter in cases of recklessness now used in the Seventh Circuit and most others as well. In accord, see *Rolf v. Blyth, Eastman Dillon & Co., Inc.*, 570 F.2d 38 (2d Cir. 1978) (Quoting with approval the Seventh Circuit's definition); *McLean v. Alexander*, 599 F.2d 1190 (3d Cir. 1979) (citing with approval the Seventh Circuit's *Sundstrand* definition); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017 (6th Cir. 1979) (wherein the Court expressed general agreement with the standard articulated in *Sundstrand*); *Broad v. Rockwell International Corporation*, 642 F.2d 929 (5th Cir. 1981) (wherein the Court adopted a standard of "severe recklessness" quoting with approval the language of the *Franke* decision cited in *Sundstrand*). In addition, although the First Circuit, Eighth Circuit, and Tenth Circuit have not directly adopted a definition, each has commented approvingly on the standard established by the Seventh Circuit — *Hoffman v. Estabrook & Co., Inc.*, 587 F.2d 509 (1st Cir. 1978) (where the Court cites with approval language from the Seventh Circuit); *Wertheim & Co. v. Codding Embroy. Sciences, Inc.*, 620 F.2d 764 (10th Cir. 1980) (where the Court approvingly cites the Seventh Circuit's standard of scienter); *Stokes v. Lokken*, 644 F.2d 779 (8th Cir. 1981) (wherein the Court cites to a parallel SEC DISCIPLINARY PROCEEDING CASE and suggests that conduct must be "at the very least . . . grossly reckless." 644 F.2d at 783).

It is obvious, to a greater or lesser degree, that most Circuits have adopted the more restrictive definition of scienter mandated by *Ernst & Ernst*. The Ninth Circuit is the one prime exception to this situation. Given this divergence in Opinion and definition, it is critical that this Court finally resolve the question. Such a final resolution by this

Court will bring all Circuits into compliance and uniformity, thus eliminating any confusion for both Courts and litigants alike.

IV.

BY IGNORING THE FINDINGS OF FACT OF THE DISTRICT COURT THAT THERE WAS NOTHING IN THE RECORD TO JUSTIFY AN INFERENCE OF RECKLESSNESS ON THE PART OF PETITIONERS, THE COURT OF APPEALS, IN EFFECT, REINSTATED A NEGLIGENCE STANDARD PREVIOUSLY REJECTED BY THIS COURT.

In *Ernst & Ernst*, this Court clearly established the rule that liability under Section 10(b) would require a showing of scienter — "a mental state embracing intent to deceive, manipulate, or defraud." 425 U.S. 194, fn. 12. Clearly rejecting the less strict standards of negligence, the Court left several questions unresolved including the question of recklessness. The Court also reserved for later determination the issue of whether scienter was a necessary element in a 10(b)/Rule 10b-5 injunctive relief action. The latter question was decided in the affirmative in *Aaron v. Securities & Exchange Commission*, 446 U.S. 680, 100 S.Ct. 1945 (1980). It would appear that *Ernst & Ernst* and *Aaron* reflect a pattern of this Court to require some degree of culpable scienter before imposing liability in Section 10(b) cases. It would seem appropriate at this time for the Court to "dot the i" and settle the last unresolved question of recklessness.

If the Court decides to accept recklessness as an adequate showing of scienter in Section 10(b) cases, there are several compelling reasons for adopting the more restrictive definition. First, the trend of this Court as noted above would seem to indicate a more restrictive definition for the sake of philosophical consistency. Second, the over-all consensus of most circuits appears to favor the more restrictive interpretation, as noted above. Finally, as a policy matter, a

more restrictive definition would best protect all parties to securities dealings. Certainly, sympathy toward innocent, defrauded victims should be encouraged. However, just because a party is a "deep pocket Defendant" with marginal involvement in a case should not permit Plaintiffs to avoid the primary Defendants in favor of more financially lucrative targets. Many recent Securities cases, especially in the area of secondary liability and Section 20 "controlling persons" theories have been cases involving such an approach. *Ernst & Ernst* is only one such case. It is not sound law to construct liability based, bottom line, on the ability of a Defendant to "share the loss" with a less affluent victim.

It could be argued that flexible duty standards are inappropriate in Section 10(b) cases. Indeed, the Court partially suggested this in footnote 12 to *Ernst & Ernst*, 425 U.S. at 194. Although negligence actions may appropriately fashion sliding scales for mental state, in intentional conduct cases, "scienter is scienter". If proof of scienter is required for liability (and this could include recklessness), it should make little difference who the Defendant is. A unitary and standard definition of scienter (or recklessness) is the cleanest, most logical, and best approach to be taken.

However, even if this Court would decide that a divided standard of culpability should be imposed for secondary, as opposed to primary, parties in Section 10(b) cases, the most appropriate approach would be one which would place an even higher standard of proof of scienter in secondary actor cases. The Second and Third Circuits have most cogently recognized the essential unfairness of imposing vicarious liability on parties who are removed from the actual fraud. Therefore, they have established a standard of "culpable participation" for liability for secondary or "control person" Defendants. Basically, they require that the control person be a culpable participant in the activities of the con-

trolled person whose conduct violates the securities laws. *Gordon v. Burr*, 596 F.2d 1080 (2d Cir. 1974); *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973); *Rochez Bros. Inc. v. Rhoades*, 527 F.2d 880 (3d Cir. 1975). If this Court decides to adopt such a split standard, such a showing of scienter would be most appropriate in the instant case. This Court should clearly establish that where one is dealing with "secondary or vicarious" liability, a showing of scienter should be more than mere happenstance or coincidental involvement.

Under the stricter definitions of recklessness indicated above, the Court of Appeals in the instant case would fall far short of the necessary showing of scienter to impose liability on Petitioners. However, it should also be pointed out that even under the less strict standards, the Court of Appeals did not correctly apply the scienter standards.

The Court of Appeals indicated that the showing below (in the District Court) met a stricter culpability standard. They based their conclusion upon the bare facts that one principal Defendant (Webley) deposed that he had helped Petitioners to execute trust deeds and promissory notes which secured the investments of Respondents. (Pet.App. 4.) At best, the record indicates that Petitioners were negligent in not following the details of what the primary Defendants (Webley and Bauer) were doing, and in signing documents which were placed before them by Bauer and Webley without questioning those documents. Contrary to the bald assertion and obvious desire of the Court of Appeals to find this to be an adequate level of scienter, the facts do not support such a finding. Although the Court of Appeals "inferred" recklessness from such trust deed and promissory note signatures (Pet.App. 6), such an inference is unsupported by the record. In fact, there is precious little to indicate, and the record is painfully bare of any real facts,

that even negligent, let alone reckless or culpable participation, occurred. As the District Court noted, the uncontroverted facts showed that the primary Defendants acted beyond their authority (Pet.App. 11); that at no time did Petitioners make any representations to Respondents (Pet.App. 12); that Petitioners not only did not have knowledge of the primary Defendants' actions, but they themselves relied upon the good faith dealings of the primary Defendants. (Pet.App. 13.) All of the above were uncontroverted factual findings of the District Court. (Pet.App. 13-14.) In contrast to this record, the Court of Appeals found that mere execution of trust deeds and promissory notes by Petitioners supported an *inference* of scienter. (Pet.App. 6.) However, the District Court specifically found as a matter of material, undisputed fact that Petitioners had no reasonable grounds to believe that any misrepresentations were being made to Respondents by the primary Defendants and were in fact totally without scienter in their dealings with Respondents. (Pet.App. 14.) Under these circumstances, the decision of the Court of Appeals clearly was erroneous and applied a standard of scienter unacceptable to this Court.

Under circumstances such as these, a Trial Court's Findings of Fact are binding on an Appellate Court unless clearly erroneous. Fed.R.Civ.P. 52(a). A parallel statement of this rule applied to similar facts is found in *Wertheim & Co. v. Codding Embroy. Sciences, Inc.*, 620 F.2d 764 (10th Cir. 1980) at 766, wherein the Court stated:

> "The trial court's finding in the instant case that though the [defendants] acted negligently, they did not have any intent to deceive and acted in complete good faith with [plaintiff] is a finding of fact and is well within the evidence presented to the trial court. The issue as to a person's state of mind almost invariably presents an issue of fact. Under these circumstances, we, as an

> appellate court, are not at liberty to overturn the trial court's determination that there was no intentional misconduct on the part of the [defendant]."

In agreement with this principle is the statement of the Court in *Rolf v. Blyth, Eastman Dillon & Co., Inc.*, 570 F.2d 38 (2d Cir. 1978) at page 43 wherein the Court states:

> "We are bound by the district court's findings, as we discern them, on the basis of the clearly erroneous rule. Fed.R.Civ.P. 52(a) . . . [The court then further comments on the undesirability of substituting judgment or facts] . . . for that of the trial judge, who was in a superior position to appraise the evidence."

The Trial Court's granting of the Motion for Summary Judgment based upon lack of scienter was correct. The ruling of the Court of Appeal, misapplying an inappropriate standard of scienter, was clearly erroneous and should be reversed.

CONCLUSION.

For each and all of the foregoing reasons, a Writ of Certiorari should issue to review the Judgment and Opinion of the Ninth Circuit.

Dated: July 26, 1982.

Respectfully submitted,

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APPENDIX A.

Ninth Circuit Memorandum.

United States Court of Appeals for the Ninth Circuit.

Dorthea Nyberg, Trustee for Connie Louise Nyman and Larry Charles Nyman; Dorthea Nyberg, Executrix of the Estate of Lewis Marvin, Deceased; Dorthea Nyberg, Individually; Donald Nyberg, Individually; Margaret Harvin, Individually; Margaret Ellis, Individually; Fred Thomson, Co-Trustee; Inland Lumber Company Profit-Sharing Trust; and Lorraine K. White, Individually, Plaintiffs-Appellants, vs. Thomas E. Johnston; Shirley L. Johnston; Richard S. Hallmark; Vivian Hallmark; William T. O'Brien; Vista Del Verde, Inc.; Vista Del Verde Corporation; Condor International Corporation; Vista Del Verde Company, Robert J. Krause and Louis A. Krause, Defendants-Appellees. No. 81-5200. D.C. NO. CV 76-983-FW.

Filed: April 30, 1982.

Appeal from the United States District Court for the Central District of California. Honorable Francis Whelan, District Judge, Presiding.

Argued and Submitted March 1, 1982.

Before: WRIGHT, ALARCON, and REINHARDT, Circuit Judges.

Plaintiffs allege that Bauer and Webley (who are not parties to this appeal) induced them to invest in real estate developments controlled by appellees. These investments apparently soured, and the plaintiffs brought suit against Bauer, Webley, and the appellees alleging that they had violated various federal securities laws and regulations. The appellees (moving defendants) successfully moved for summary judgment. That judgment is the subject of this appeal.

A party is entitled to summary judgment where (1) there are no disputed issues of material fact, and (2) based upon the established facts, the moving party should prevail as a matter of law. *Pegasus Fund, Inc. v. Lararenta*, 617 F.2d 1335, 1339 (9th Cir. 1980); Fed. R. Civ. P. 56(c). Upon review, we must interpret the evidence in a manner most favorable to the plaintiff. *Gaines v. Houghton*, 645 F.2d 761, 769 (9th Cir. 1981). "Cases where intent [here, scienter] is a primary issue generally are inappropriate for summary judgment unless all reasonable inferences that could be drawn from the evidence defeat the plaintiff's claims." *Vaughan v. Teledyne, Inc.*, 628 F.2d 1214, 1220 (9th Cir. 1980), *citing Calnet Corp. v. Volkswagen of America, Inc.*, 532 F.2d 674 683-84 (9th Cir.), *cert. denied*, 429 U.S. 940 (1976).

The plaintiffs sought to hold the moving defendants liable, as controlling persons, for the acts of Bauer and Webley under section 20(a) of the Securities Exchange Act of 1934, codified at 15 U.S.C. § 78(t) (1981). That section states that:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally . . . unless the controlling person acted in good faith and did not directly or indirectly induce and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. § 78(t)(a).

To prevail under this section, plaintiffs must prove that the acts of the controlled persons constituted a violation of securities law, and that defendants were controlling persons within the meaning of section 20(a). *Christoffel v. E.F. Hutton*, 588 F.2d 665, 667 (9th Cir. 1978). Here, plaintiffs did contend that Bauer's and Webley's acts violated SEC

rule 10b-5 (17 C.F.R. 240.10b-5). Defendants did not challenge that contention for purposes of the summary judgment motion and no issue is presented with respect to that contention. The plaintiffs also alleged that the moving defendants were controlling persons in regard to Bauer and Webley. In granting summary judgment the district court ruled that the plaintiffs had failed to raise a genuine issue of material fact as to whether: (1) the moving defendants were "control persons" within the meaning of section 20(a), and (2) they possessed the necessary element of intent in regard to Bauer's and Webley's actions.

In attempting to define "control" within the meaning of section 20(a), the focus has been on the ability, or potential ability, of an individual to influence or control the subordinate's activities. *Rochez Bros., Inc. v. Rhoades*, 527 F.2d 880, 890-91 (3d Cir. 1975). The SEC has defined control, in the context of its registration and reporting requirements, as meaning, "the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." 17 C.F.R. § 230.405(f) (1979). This definition has been used in section 20(a) cases by other circuits. *See G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 957-58 (5th Cir. 1981); *Rochez Bros.*, 527 F.2d at 890-91. Our own circuit has ruled that control requires "only some indirect means of discipline or influence short of actual direction to hold a 'controlling person' liable." *Strong v. France*, 474 F.2d 747, 752 (9th Cir. 1973), quoting *Myrel v. Fields*, 386 F.2d 718, 738 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

It is undisputed that Webley was an employee of the moving defendants and that Bauer had a contractual relationship with them that covered his solicitation of investments. The moving defendants contend that Webley's ac-

tivities exceeded the scope of his employment and that Bauer was an independent contractor over whom they exercised no control. In his deposition Webley stated that his acts were within the scope of his employment and corporate authority. He also said that he aided the moving defendants in the execution of trust deeds and promissory notes that secured the plaintiff's investments. Reviewing the record on summary judgment, including the evidence and the inferences which may be drawn therefrom, we conclude that a genuine issue of material fact was raised as to whether moving defendants possessed the requisite power and authority to make them "controlling persons."

In *Christoffel v. E.F. Hutton*, 588 F.2d 665, we reviewed decisions of the Second and Third Circuits that required culpable participation in the securities violations before a defendant could be characterized as a controlling person. *Christoffel*, 588 F.2d at 668-69. In that case we found that the defendant did not participate in the alleged securities fraud and ruled that: "We need not decide in this case whether, like the Second and Third Circuits, we will require that the person who has participated in the acts of another must be "culpable." It is enough to dispose of this case to hold that Hutton can not be a "controlling person" . . . because it was not a participant. . . ." *Id.* at 669. It is far from clear that we would consider a showing of "culpability" a prerequisite to a determination that an individual or entity is a "controlling person." Under the statute, good faith is a defense, and that may be the appropriate context in which to consider matters relating to the controlling persons' culpability. However, since appellant's showing below met the stricter "culpability" standard, we need not decide whether it was necessary for it to do so.

We now turn to the evidence relating to the issue of whether moving defendants were culpable participants in

the alleged fraud. Krause's, Johnston's, and Hallmark's signatures appear on promissory notes and trust deeds that were issued as security for the plaintiffs' investments. The plaintiffs have argued that the security was worthless and that the providing of worthless security constituted a significant aspect of the alleged fraud. The trust deeds were on real property that was subject, at least in part, to a prior lien, and plaintiffs were not apprised of this fact. While the record is not entirely clear on this point, we cannot say at this point that plaintiff's contentions are erroneous or that they should be prohibited from attempting to prove their claim at trial. Viewing the evidence in the light most favorable to the plaintiffs, we conclude that a genuine issue of material fact exists as to whether the moving defendants were culpable participants in the alleged fraud.

In ruling on the section 20(a) claim, the district court stated that moving defendants "had no reasonable grounds for believing that fraudulent or unlawful activities were taking place. Absent scienter, moving defendants cannot be held liable as controlling persons. . . ." Memo of Decision p. 7. It is settled in this circuit that recklessness satisfies a scienter requirement. *Kiernan v. Homeland, Inc.*, 611 F.2d 785, 788 (9th Cir. 1980); *Nelson v. Serwold*, 576 F.2d 1332, 1337 (9th Cir. 1978). Recklessness may be established by showing that defendants "had reasonable grounds to believe material facts existed that were misstated or omitted, but nonetheless failed to obtain and disclose such facts." *Kiernan*, 611 F.2d at 788. In summarizing the section 20(a) defense the Fifth Circuit has stated that:

> We hold therefore that the burden on the controlling person is to establish that he did not act recklessly in inducing, either by his action or inaction, the act or acts constituting the violation of 10b-5. Or, . . . the question is whether the defendant acted recklessly in

> failing to do what he could have done to prevent the violation.

G.A. Thompson Co. v. Partridge, 636 F.2d 945, 960 (5th Cir. 1981).

The moving defendant's recklessness may be inferred from the same evidence that supports an inference of their culpable participation in the fraud, *i.e.*, the execution of the trust deeds and promissory notes. Thus, summary judgment could not properly be granted on the ground of lack of scienter.

Plaintiffs also sought to hold the moving defendants liable as aiders and abettors of the securities fraud. An individual may be liable as an aider and abettor of a 10b-5 violation to the extent he "acted with knowledge or wanton and reckless disregard for the facts indicating fraud, and provided substantial assistance in commission of the fraud." *Little v. Valley National Bank of Arizona*, 650 F.2d 218, 222-23 (9th Cir. 1981). The district court predicated the aider and abettor part of its summary judgment decision on the absence of scienter on the part of the moving defendants. The evidence and arguments involved here are the same as those involved in our earlier discussion of scienter. Accordingly, the grant of summary judgment on plaintiffs' aider and abettor claim was not proper.

We do not mean to suggest that the evidence discussed in this memorandum is the only evidence that supports our conclusion that summary judgment was improper. We see no need, however, to engage in any more extensive analysis of the affidavits and declarations which were before the district court. The evidence we have analyzed herein is sufficient to require reversal of the district court's order.

By agreement of the parties at oral argument, the spouses of the principal moving defendants are to be dismissed from this case on remand. In ruling on the motion for summary

judgment, the district court apparently did not rely on, or consider, the activities of the various corporate entities and business concerns that are defendants in this action. Their role has not been addressed by the appellants or appellees and no one has argued that these defendants should be treated differently than the individual defendants. Accordingly, we reverse as to these defendants as well.

Finally, we note that at the time of the summary judgment motion appellants presented no evidence to rebut the contention of William O'Brien, fully supported by his affidavit, that he played only a peripheral role in these events and was in no way involved in or aware of any wrongdoing. Nor did appellants make any separate argument in their briefs or during their oral presentation before us as to this individual moving defendant. Consequently, we affirm the summary judgment as to O'Brien.

Affirmed in part, reversed in part for further proceedings consistent with this memorandum.

APPENDIX B.

Memorandum of Decision.

United States District Court, Central District of California.

Dorothea Nyberg, et al., Plaintiffs, vs. Thomas E. Johnston, et al., Defendants. No. CV 76-983-FW.

Filed: February 2, 1981.

In this action, Defendants Thomas and Shirley Johnston, Richard and Vivian Hallmark, William T. O'Brien, Robert and Lois Krause, Vista Del Verde, Inc., Vista Del Verde Corporation, Vista Del Verde Company and Condor International Corporation, brought on for hearing a motion for summary judgment. The Court has heretofore announced its decision granting the moving Defendants' motion. The following constitutes the memorandum of the Court setting forth the grounds for its decision.

Plaintiffs in this action seek damages for violations of the provisions of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder. Plaintiffs made capital contributions to two limited partnerships, Park West Investment Company and Summerhill, Ltd., and made loans to a Utah corporation, Ski Park City West, Inc. (hereinafter "SPCW"), which investments were allegedly solicited and obtained by Defendants Steven Bauer and Roy Webley, who are not parties to the motion, by false representations and material omissions in violation of Section 10(b) and Rule 10b-5.

Plaintiffs oppose the motion of the moving Defendants on the theory that they were "controlling persons" of Defendants Bauer and Webley within the meaning of Section 20(a) of the Act, 15 U.S.C. § 78t(a), and further on the theory that moving Defendants were aiders and abettors of

Defendants Bauer and Webley in the violations of the securities laws.

The material undisputed facts, which are established on the record now before the Court, follow. Pursuant to an agreement entered into in 1972, Defendant Vista Del Verde Company, a California limited partnership, obtained an option to purchase a controlling interest in SPCW from Life Resources, Inc., a publicly traded Utah corporation which held approximately 80% of SPCW's outstanding common stock. SPCW operated a ski resort in Summit County, Utah, called Park City West. Defendant Vista Del Verde Company was engaged in the business of real estate development; its limited partner was Defendant William T. O'Brien, and its general partner was Vista Del Verde, Inc., a California corporation in which Defendants Richard Hallmark and Thomas Johnston were the sole directors. Defendants Hallmark and Johnston also owned and controlled two of the other corporate Defendants in this action, Vista Del Verde Corporation and Condor International Corporation.

In December of 1972, Defendants Hallmark, Johnston, Krause and O'Brien, became directors of SPCW, with Johnston, Hallmark and Krause, becoming officers in SPCW. Defendant Webley became employed by Vista Del Verde Company in an administrative capacity in January of 1973, as well as becoming a vice president of Vista Del Verde, Inc., and Vista Del Verde Corporation.

Defendant Steven Bauer owned and controlled Defendant Investment Controlled Research Corporation (hereinafter "ICR"), an investment advisory firm. All of the Plaintiffs in this action, with the exception of Margaret Ellis, were clients of Bauer and ICR prior to the time of the investments which are the subject of this action. Bauer was an acquaintance of Webley, and at some time prior to 1973, Webley

introduced Bauer to Defendants Richard Hallmark and Thomas Johnston.

In July of 1973, SPCW and Vista Verde Company entered into a joint venture agreement for the development and construction of condominium and commercial units on land owned by SPCW adjacent to the Park City West ski resort. Prior to this time, in the Spring of 1973, Defendant Bauer had meetings with Defendants Johnston, Hallmark and Webley, to discuss the possibility of Bauer providing funds for Vista Del Verde Company developments, including the Park City West venture, on a project-by-project basis, and Bauer agreed to do so.

According to the affidavits of Plaintiffs, Defendants Bauer and Webley solicited Plaintiffs' investments about and after June, 1973. In June of 1973, Park West Investment Company, a limited partnership, was formed with funds contributed by certain of the Plaintiffs herein, who were given limited partnership interests in the entity. The general partner of Park West Investment Company was Vista Del Verde Corporation, the partnership certificate being executed on behalf of the corporation by Defendant Webley, as vice president. In Ocotber of 1973, after further solicitations of Plaintiffs by Bauer and Webley, Summerhill, Ltd., a limited partnership, was formed with funds contributed by Plaintiffs Lewis and Margaret Marvin and Lorraine K. White. Such Plaintiffs received limited partnership interests, with the general partner being Vista Del Verde Corporation, the partnership certificate being executed on behalf of the corporation again by Defendant Webley, as vice president. Both of these partnerships, Summerhill, Ltd., and Park West Investment Company, provided financing to SPCW for the ski resort development.

The record before the Court does not disclose that Vista Del Verde Corporation authorized the execution of the Park

West Investment Company and Summerhill, Ltd., partnership certificates by Defendant Webley as vice president. Further, Defendants Hallmark and Johnston, the sole directors and shareholders of Vista Del Verde Corporation, stated, in substance, in their affidavits that Webley was not authorized to do so. Their affidavits are uncontroverted by Plaintiffs.

In June of 1974, Defendant Bauer entered into an agreement with SPCW, Bauer agreeing to provide funds for the ski resort development in return for a percentage of profits from the sale of the completed units. Defendant Savery Nash, who had become the president of SPCW in late 1973, signed the agreement on behalf of the corporation. Early that same month, June of 1974, following solicitations by Defendant Bauer, Plaintiff Dorothea Nyberg, as Executrix of the estate of her father, Lewis Marvin, loaned SPCW $106,000.00 in funds from the estate.

Thereafter, in August of 1974, Bauer entered into a second agreement to provide funds to SPCW ski resort project. In the latter part of September of 1974, after a meeting between Bauer and Plaintiffs Donald and Dorothea Nyberg, the Nybergs loaned an additional $65,000.00 of their own funds to SPCW, and in October of 1974, Plaintiff Dorothea Nyberg loaned an additional $63,100.00 of funds from the Nyman Trust to SPCW, after further solicitations by Defendant Bauer.

Plaintiffs' affidavits state that they made the foregoing investments on the basis of Defendants Bauer and Webley's fraudulent representations that their investments would be safe, profitable, and adequately secured by real property or deeds of trust. Plaintiffs' affidavits also state that Bauer and Webley omitted to tell Plaintiffs that they were partners, that Defendants Johnston and Hallmark owned and controlled Vista Del Verde Corporation, general partner of the

limited partnerships, and the identity of their principals in their fund raising endeavors. These and other allegedly fraudulent representations and material omissions form the basis of Plaintiffs' claims. (Pretrial Conference Order, Issues of Fact, ¶¶ 1-227, filed June 13, 1979.)

The record shows that at no time prior to or during the period of Plaintiffs' investments did any of the individual moving Defendants make any representations to Plaintiffs, or at any time, regarding the limited partnerships, Park West Investment Company and Summerhill, Ltd., or regarding loans by Plaintiffs to SPCW. (Pretrial Conference Order, Admitted Facts, ¶ 32.)

Plaintiffs seek to hold moving Defendants liable also as "control" persons or as aiders and abettors of Bauer and Webley's allegedly fraudulent activities.

Control Person Liability Under Section 20(a) of the Act.

Section 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78t(a) provides:

> "Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the actual acts constituting the violation or cause of action."

In order to hold moving Defendants liable on this theory, Plaintiffs have to prove that (1) Bauer and Webley's representations and omissions constitute a violation of Section 10(b) and Rule 10b-5, and (2) that moving Defendants were controlling persons, within the meaning of Section 20(a), in respect of Bauer or Webley's acts or omissions which are in violation of the securities laws except that if moving

Defendants acted in good faith and did not directly or indirectly induce the actual acts of violation there is no liability. *Christoffel v. E. F. Hutton & Co.*, 588 F.2d 665, 667-68 (9th Cir. 1978). The law is now clear that in order for liability to be imposed under Section 10(b) and Rule 10b-5, a plaintiff must prove scienter — an intent on the part of defendant to deceive, manipulate or defraud. *Aaron v. S.E.C.*, ___ U.S. ___, 48 U.S.L.W. 4609, 4611 (June 2, 1980); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 N. 12 (1976). This rule applies regardless of the identity of the plaintiff or defendant. *Aaron, supra.*

The record in the instant case discloses that there was no scienter on the part of moving Defendants. While Plaintiffs contend that Defendants should be held for trial because they acted recklessly, there is nothing in the record to justify such an inference. By way of affidavits of Defendants Thomas Johnston, Richard Hallmark, William T. O'Brien and Robert Krause, the moving Defendants have presented evidence that they had limited dealings with Defendant Bauer; were unaware of the nature of Bauer's relationship with the Plaintiffs; were not aware of the nature of any representations made to Plaintiffs by Bauer and Webley; were not aware of Webley's role in assisting Bauer in soliciting the Plaintiffs' investments; and did not assist Bauer and Webley in making any of the alleged representations to Plaintiffs. Further, the affidavits of Defendants Hallmark and Johnston establish that Bauer was acting independently as a principal in providing funds for the Park City West construction project, and that, relying on Bauer's reputation as a reputable, established stockbroker, they assumed he would comply with all applicable laws and regulations in providing such funds.

Plaintiffs have submitted exhibits, affidavits and deposition testimony in opposition, but nothing submitted by

Plaintiffs controverts the evidence presented by moving Defendants that they exercised no control over Bauer and Webley in making misrepresentations and/or omissions, and that they had no reasonable grounds for believing that fraudulent or unlawful activities were taking place. Absent scienter, moving Defendants cannot be held liable as controlling persons under Section 10(b) and Rule 10b-5.

Liability as Aiders and Abettors.

Similarly, in order to hold moving Defendants liable as aiders and abettors of Bauer and Webley's Section 10(b) and Rule 10b-5 alleged violations, proof of scienter is also required. As discussed above, moving Defendants' uncontroverted affidavits and evidence established that they had no such scienter, and they cannot be held liable as aiders and abettors.

This is a proper case for summary judgment in favor of moving Defendants and their motion should be granted.

The foregoing constitutes the undisputed material facts and Conclusions of Law of the Court. Judgment will be entered in their favor but no judgment shall be entered until the Court has signed and caused to be filed its formal judgment.

Dated this 2nd day of February, 1981.

/s/ Francis C. Whelan
FRANCIS C. WHELAN
United States District Judge

Judgment in Favor of Defendants Thomas E. Johnston, Shirley L. Johnston, Richard S. Hallmark, Vivian Hallmark, William T. O'Brien, Vista Del Verde, Inc., Vista Del Verde Corporation, Condor International Corporation, Vista Del Verde Company, Robert J. Krause and Lois A. Krause.

United States District Court, Central District of California.

Dorothea Nyberg, et al., Plaintiffs, vs. Thomas E. Johnston, et al., Defendants. No. CV 76-983-FW.

Filed: February 2, 1981.

The motion of Defendants THOMAS E. JOHNSTON, SHIRLEY L. JOHNSTON, RICHARD S. HALLMARK, VIVIAN HALLMARK, WILLIAM T. O'BRIEN, VISTA DEL VERDE, INC., VISTA DEL VERDE CORPORATION, CONDOR INTERNATIONAL CORPORATION, VISTA DEL VERDE COMPANY, ROBERT J. KRAUSE and LOIS A. KRAUSE, for summary judgment in their favor dismissing the action was duly brought on to be heard, and the Court having caused to be filed its Memorandum of Decision granting said motion; and in accordance therewith. Accordingly,

IT IS HEREBY ORDERED, ADJUDGED and DECREED that Plaintiffs take nothing, and that this action is dismissed on the merits as to Defendants THOMAS E. JOHNSTON, SHIRLEY L. JOHNSTON, RICHARD S. HALLMARK, VIVIAN HALLMARK, WILLIAM T. O'BRIEN, VISTA DEL VERDE, INC., VISTA DEL VERDE CORPORATION, CONDOR INTERNATIONAL CORPORATION, VISTA DEL VERDE COMPANY,

ROBERT J. KRAUSE and LOIS A. KRAUSE, and that Defendants do have and recover their costs in the sum of $ _____ .

Dated this 2 day of February, 1981.

/s/ Francis C. Whelan
FRANCIS C. WHELAN
United States District Judge

APPENDIX C.

Relevant Statutory Provisions.

SECTION 10(b), Sec. Exch. Act of 1934 (15 U.S.C. § 78(j))

78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —

(a) To effect a short sale, or to use or employ any stoploss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

SECTION 20, Sec. Exch. Act of 1934 (15 U.S.C. § 78(t))

78t. Liability of controlling persons

Joint and several liability; good faith defense

(a) Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

Unlawful activity through or by means of any other person

(b) It shall be unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do under the provisions of this chapter or any rule or regulation thereunder through or by means of any other person.

Hindering, delaying, or obstructing making or filing of any document, report, or information

(c) It shall be unlawful for any director or officer of, or any owner of any securities issued by, any issuer required to file any document, report, or information under this chapter or any rule or regulation thereunder without just cause to hinder, delay, or obstruct the making or filing of any such document, report, or information.

S.E.C. Rule 10b-5 (7 C.F.R. 240.10b-5 (1981))

Section 240.106-5 Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Regulation C of General Rules and Regulations, Securities Act of 1933 (7 C.F.R. 230.405(f)(1981))

. . .

(f) Control. The term "control" (including the terms "controlling", "controlled by" and "under common control with") means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.

No. [illegible]

Supreme Court of the United States

October Term, 1962

THOMAS S. JOHNSTON, *et al.*,

Petitioners,

vs.

DOROTHEA NYSWEGEN, *et al.*,

Respondents.

On Appeal from the United States District Court
for the Central District of California.

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI.

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No. 82-153

IN THE

Supreme Court of the United States

October Term, 1982

THOMAS E. JOHNSTON, *et al.*,

Petitioners,

vs.

DOROTHEA NYBERG, *et al.*,

Respondents.

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI.

Introductory Statement.

The instant case was dismissed by the District Court's granting summary judgment in defendants' favor; on appeal the propriety of this summary dismissal was the sole issue.

The legal standard for determining the liability of control persons was not in issue before the District Court nor was it an issue before the Court of Appeals. The sole issue before both courts was the existence of any genuine issue as to any material fact under FRCP 56.

Therefore, the instant Petition inappropriately seeks an advisory opinion from this Court which is tangential, if not irrelevant, to the proceedings below.

On June 4, 1982 the Circuit Court denied Petitioners' Motion for Stay of Mandate. The District Court has scheduled a trial for February 8, 1983 in this matter.

ARGUMENT.

I.

The Instant Case Does Not Present an Issue Concerning the Standards of Liability for Control Persons or Aider and Abettors.

The Petition in the instant case is premised on the argument that there is a present need, raised by the instant case, to settle the question of the requisite culpability of control persons or aider and abettors. (Petition, page 4, *et seq.*) On its face, it is apparent that the Petition is addressed to a non-issue. Nowhere in the Petition do petitioners even pose the question they claim is presented by the instant Petition. Instead, the Petition merely recites the long-standing unanswered question which was raised in the opinion of *Ernst and Ernst v. Hochfelder*, 425 U.S. 185 (1976), particularly footnote 12.

However, notwithstanding the intellectual curiosity raised by the various treatments accorded the scienter issue by post-*Hochfelder* cases, the issue of standard of liability for scienter simply is not raised by the instant case. Examining Appendix B, the memorandum of decision by the District Court, this Court can readily ascertain that the District Court simply found,

> The record in the instant case discloses that there was no scienter on the part of moving Defendants. While Plaintiffs contend that Defendants should be held for trial because they acted recklessly, there is nothing in the record to justify such an inference.
> (Appendix B to Petition, page 13)

As to the cited language makes clear, the District Court simply found as a matter of summary judgment law that there was no scienter. The District Court did not even ex-

amine the question of what constituted scienter of control persons or aider and abettors.

Appendix A which is the Ninth Circuit Memorandum reversing the District Court, makes clear that the Circuit Court merely reversed by concluding that there was "a genuine issue of material fact . . ." (Appendix A to Petition, page 5). The Circuit Court simply talked in terms of "culpable participation" and did not examine what was the legal standard necessary in order to hold a defendant liable under Section 10(b) or Rule 10b-5 as control persons or aider and abettors. As made clear by the Circuit Court, the Court merely decided, ". . . summary judgment could not properly be granted on the ground of lack of scienter." (Appendix A to Petition, page 6)

II.

This Is Not the Kind of Case in Which the Court Should Grant a Writ of Certiorari.

The law is well established that the Supreme Court will not consider questions which are not pled or briefed in the District Court or the Court of Appeals. *Miree v. DeKalb County, Georgia*, 433 U.S. 25, 33-34 (1977). The wisdom behind this idea is obvious and is grounded on the venerated doctrine of judicial restraint, that the Court will only decide "actual controversies" and does not give "opinions upon moot questions or abstract propositions." *Local No. 8-6, Oil, Chemical and Atomic Workers International Union, AFL-CIO v. Missouri*, 361 U.S. 363, 367 (1960).

Other Courts, facing other fact patterns, have articulated this doctrine of judicial restraint in different fashions. For example, see *Thorpe v. Housing Authority of City of Durham*, 393 U.S. 268, 284 (1969) in which the Court stated

> We do not sit however, "to decide abstract, hypothetical, or contingent questions . . . or to decide any constitutional question in advance of the necessity for its decision . . ."

III.

Under the Rationale of the Circuit Court's Opinion, No Issue Has Been Raised as to Scienter.

The Petition contains a highly complex, even convoluted argument tracing different theories, by different Courts, of standards for culpability for Rule 10b-5 liability. The discussion ranges from a recklessness standard to far stricter standards of intentionality in order to posit control person liability. On page 21 of the Petition, the Petitioners incorrectly state,

> Under the stricter definitions of recklessness indicated above, the Court of Appeals in the instant case would fall far short of the necessary showing of scienter to impose liability on Petitioners.

This statement from the Petition is patently incorrect since the Circuit specifically found:

> It is far from clear that we would consider a showing of "culpability" a prerequisite to a determination that an individual or entity is a "controlling person." Under the statute, good faith is a defense, and that may be the appropriate context in which to consider matters relating to the controlling persons' culpability. However, since Appellant's showing below met the stricter "culpability" standard, we do not decide whether it was necessary for it to do so. (Appendix A of Petition, page 4)

This language indicates quite specifically that the Court of Appeals found that quite a strong showing, sufficient to meet a "stricter culpability standard," had been made by the Plaintiffs. Accordingly, other questions as to "good

faith'' and the degree of intentionality for culpability simply were not addressed by the Circuit Court. The Circuit Court even went on to state that there was other evidence, not discussed in the Memorandum, which supported the conclusion that summary judgment was improper. (Appendix A of Petition, page 6)

Conclusion.

In short, the instant Petition does not merit much discussion since it attempts to present an issue to the Court which, at best, is tangentially in the case. The Petition inappropriately seeks an advisory opinion. The instant case is a ''garden-variety'' matter of summary judgment law.

For these reasons, the Petition should be denied. The case should proceed to trial as scheduled.

Respectfully submitted,

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Attorneys for Respondents.